FOMC Briefing
Donald L. Kohn
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LONG-RUN POLICY OPTIONS

In considering its long-run ranges, the issues facing the Committee regarding the broader aggregates differ from those associated with M1, and so my discussion, like the bluebook, will be divided along those lines. The Committee's discussion at the last meeting suggested that the treatment of the broad aggregates and their weight in policy implementation would remain the same as in 1986--that is, target ranges for the broad money aggregates would be established, with the understanding that their behavior would continue to be interpreted in light of other information about the economy and financial markets bearing on the direction of policy. The question on the broad aggregates is whether to adopt the tentative targets for 1987 set forth last July, given as long-run alternative II in the bluebook, or to raise or lower them--alternatives I and III respectively.

Staff projections suggest that growth around the middle of the tentative 1987 ranges for M2, M3, and debt would be consistent with an outcome for the economy like that outlined in the greenbook. As noted by Mr. Kichline, this forecast is thought to involve interest rates close to current levels over 1987. Under such conditions, the velocities of M2 and M3 would be expected to return toward their trend growth rates. In the case of M3, a trend velocity decrease of around 1 percent seems reasonable for 1987; for M2, whose velocity has been essentially trendless over long periods, some further decline might be in store, owing primarily to the lingering effects of the large downward movements in short-term rates of last year. However, any such decline should be much smaller than in the last few years--perhaps also on the order of 1 percent. Thus, under these conditions, growth of around 7 percent would be expected for both M2 and M3. The velocity of debt seems likely to continue to drop--though less rapidly than last year--given the apparent willingness of borrowers to build up debt obligations over recent years and of lenders and savers to accumulate them. Debt growth is expected to slow to a little below 10 percent, well within the tentative 8 to 11 percent range.

The higher growth rates of alternative I would allow somewhat faster income growth if velocity behaves as expected, or would give greater scope for maintaining satisfactory economic growth against the contingency of another sizable decline in velocity. Such a decline might be induced by further substantial downward movements of nominal interest rates in association with much weaker than projected performance of the real economy or prices, or by stronger than anticipated demands for liquidity. While alternatives II and III allow for some velocity declines, alternative I gives the most scope for continued rapid money growth should that be needed to sustain expansion under these conditions. Alternative I also bows in some sense in the direction of historical experience, given the tendency of M2 and M3 to grow at rates above the 8-1/2 percent upper limit of the tentative range through the 1970s and 1980s, though there are reasons to think that the factors responsible for this sort of growth will be present in 1987. Raising the range from the tentative specifications would not be unprecedented, and might be explained by reference to the outcome for 1986--both in terms of velocity declines and of actual M2 and M3 growth, which was above the upper ends of the tentative 1987 ranges.

The lower growth specifications of alternative III might be viewed as appropriate should the Committee put more weight on the risks or costs of a significant strengthening of inflation, especially in the context of a need to restrain domestic demand to foster needed external adjustments given limited progress on the fiscal side. A reduction in the ranges from 1986 to 1987--under alternative II as well as alternative III--would more clearly signal the Federal Reserve's intention not to allow the greater price pressures of 1987 associated with energy and dollar developments to become the precursor of a more generalized resurgence of inflation. If prices do pick up substantially, rapid expansion of money relative to targets, should interest rates lag the strengthening of inflation, would more quickly signal the need to firm policy under alternative III, and once rates begin to move higher, velocity could rise appreciably, perhaps necessitating growth at even the lower end of this alternative. This alternative also could be seen as more appropriate if demands for liquidity were somewhat weaker than the staff foresees, as is suggested by many of the M2 model forecasts, which show this aggregate running below the 7 percent midpoint of the tentative range. M2 velocity already is below its historic range, perhaps suggesting the scope for a considerable rebound at some point--a rebound that would be less readily accommodated in alternative II, with its 5-1/2 percent lower end.

Turning to M1, the staff expects growth in the neighborhood of 10 percent, consistent with the income and interest rates in the greenbook forecast. Our confidence in this as a point estimate is, understandably, not very high, given recent experience and uncertainties about the response of depository institutions and depositors to historically low opportunity costs on NOW accounts. The basic point is that M1 growth is likely to remain well in excess of GNP next year, largely reflecting continued flows into OCDs, but in the assumed absense of further major interest rate movements, the rate of velocity decline and pace of M1 growth should moderate from 1986. However, the odds would not seem to favor its slowing into the tentative 3 to 8 percent range set last July. Models of M1 demand generally suggest that growth would fall within the tentative range, but their reliability is open to question in the context of what is fundamentally an unprecedented situation involving narrow opportunity costs and deregulated deposits. Even the higher staff expectation requires a marked deceleration of both demand deposits and OCDs in 1987.

In addition to uncertainties about offering rates and depositor behavior, any M1 forecast is particularly vulnerable to unanticipated movements in market interest rates. These would be expected to have a very marked effect on M1 given the high interest elasticity of the narrow aggregate at the current configuration of market and deposit interest rates. These considerations, along with the expectations of rapid growth, raise questions about the 3 to 8 percent tentative range specifications and more generally about how to treat M1 in the implementation of policy in the communication of the Committee's intentions to the public. In July, the Committee indicated that the tentative M1 range would be subject to especially close scrutiny, resting as it did on an assumption of more normal velocity patterns. At the last meeting there seemed to be a consensus that in the current circumstances M1 should not be afforded the same treatment as M2 and M3 in terms of setting and adhering to target ranges. That still leaves open a number of possibilities.

One would be simply to forego any numerical specification for M1 or even a sense of where it might be headed this year. This approach could be implemented by something like the variant I directive language, without the material in the first set of brackets. Under this approach, the Committee would be saying in effect that uncertainty about M1 behavior is so great that at this point nothing very useful can be said about how it might grow consistent with satisfactory economic performance. The Committee would continue to follow this aggregate and evaluate its velocity movements, but restoration of M1 as a target or even monitoring variable would have to await signs of a more normal and predictable relationship of money to income.

If the Committee believed that M1 had more value as a guide to policy than is implied by this approach, or was concerned that it might be difficult to bring M1 back at a later time, it could set a range for M1, indicating that because of uncertainties surrounding velocity behavior, growth outside the range might very well be acceptable in a variety of circumstances. Under this approach, which could be implemented by language such as that given in variant II, M1 would have more visibility, but the public would be on notice that the Committee did not consider the range to have the same status as ranges for the broad aggregates. Such a range would convey to the public a sense of what the Committee expected over the coming year, and if it were below last year's results, it would also indicate that continued M1 growth at rates like those of the past two years would not seem to be compatible with attaining and sustaining price stability over the longer run. Having a range might suggest that there are circumstances when growth outside the ranges could have some weight in the implementation of policy. There is some risk that no matter how carefully the words were chosen, the act of putting forth a range might be taken as connotating the placement of more weight on this aggregate and more importance to the upper and lower ends of the ranges than might be warranted, although experience with the debt aggregate indicates that this need not be the case. Given the uncertainties, a range that realistically was expected to encompass a high proportion of acceptable outcomes would be very wide--probably even wider than the current 5 percentage point range--and very high by historic standards.

An intermediate approach between these might be to forego a range, but to indicate in some qualitative form the Committee's expectations for M1 growth next year. The more precise these expectations were stated, of course, the greater the danger that they would not be achieved or that the FOMC would be expected to react to deviations when it would not want to do so. The language in brackets in variant I would indicate only that some slowing was expected. It also suggests why the lack of a slowing might be a cause for concern, or why a very marked slowing might be acceptable. These latter statements are an attempt to define some role for M1 at least as a backup indicator to other information indicating the course of the economy and the thrust of policy.

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SHORT-RUN POLICY OPTIONS

As background for Committee discussion of the short-run policy alternatives, I thought it might be useful to expand a bit on some of the considerations behind the staff projections of interest rates and money growth.

With respect to the interest rate outlook, as mentioned yesterday, we expect some factors producing unanticipated tightness in the funds market to be at least partly reversed over the intermeeting period. For alternative B this would mean funds trading centered around 6 percent. With more normal behavior of the Treasury balance, required reserves and float, banks may be less inclined to manage reserve positions unusually conservatively. And continued publication of borrowing levels around $300 million should calm any market concerns that the Federal Reserve had in any fundamental way tightened up on reserve availability. Under these conditions other short-term rates also would be expected to retrace some of their recent increases. However, the relationship between borrowing levels and the federal funds rate is fairly loose, even abstracting from some of the short-run factors just cited. The greater risk to this projection may be that in the face of cautious reserve management at large banks and a lack of liquidity pressures at smaller institutions funds could trade more often above than below 6 percent, leaving less scope for declines in other rates.

With regard to the outlook for the aggregates, we expect a considerable slowing in growth of all the Ms over February and March relative to the December-January average. The pattern of growth over the four months is greatly affected by the distortions around year-end and much of the slowing in February-March represents the subsequent dissipation of these effects. By late January, demand deposits had returned to their level of November, suggesting little net effect from this source on the February level. Overall, these variations are around what we believe to be a moderating trend in monetary expansion, as the impact of earlier interest rate declines abates. This is suggested by projections of 7 percent growth for M2 in March and 11-1/2 percent for M1 -- both considerably below the pace of last year. M3 growth also is projected to slow over the two months. For this aggregate the year-end effects have not entirely been reversed, as many of the year-end loans remain on bank books, along with the CDs issued to fund them.

Partly as a result, M3 growth over November to March is now expected at 7-1/2 percent, slightly to the high side of the Committee's current 7 percent path. Even with the marked slowing in February-March, and the washing out of year-end effects, M2 growth is projected at around 8 percent over the four-month period. In this regard it may be worth noting that the seasonal revisions themselves have raised M2 growth rates for a given NSA path over 1 percentage point over the four-month period. M1 is projected to grow at a 15-1/2 percent rate over the four months, and with the demand deposit bulge having washed out, OCDs again are expected to account for the rapid growth. The bluebook retained the November base for the short-run targets in order to minimize the impact on money growth paths of the year-end distortions. If the Committee did shift to the higher December base, however, the staff projections suggest that it could more confidently retain the existing 7 percent short-run specifications for the broad aggregates.

The differences among the three alternatives in terms of money growth outcomes through the first quarter are fairly small, given that we are already halfway through the quarter. The impact of any near-term change in money market conditions would likely be felt more in the second quarter, when the easier conditions of alternative A might give rise to continued M2 growth along the upper end of its range, while alternative C would increase the odds on M2 growth close to the midpoint of its range. The choice of alternatives, or perhaps of any tilt to the directive language dealing with intermeeting adjustments, would seem to rest on much the same kind of considerations discussed with respect to the long-term alternatives. The easier conditions of A or assymetrical language such as now exists in the directive would seem most appropriate if the risks were seen weighted toward a shortfall in activity with little resurgence in price pressures--perhaps outweighing concerns about the potential for intensified dollar weakness. The tighter conditions of C, or a greater readiness to tighten than to ease over the intermeeting period, might be associated with concern about inflation and the dollar, particularly in the context of stronger economic data of late.

Variant I for M1

With respect to M1,the Committee recognized that, based on experience, the behavior of that aggregate and its appropriate growth must be judged in the light of other evidence with respect to economic activity and prices; fluctuations in M1,among other factors, have become much more sensitive in recent years to changes in interest rates. The Committee anticipates that growth in M1 should slow over 1987 as a whole. However, in the light of its sensitivity to a variety of influences, the Committee decided not to establish a precise target for its growth over the year as a whole at this time. Instead, appropriate changes in M1 during the course of the year will be evaluated in light of the behavior of its velocity, developments in the economy and financial markets, and the nature of emerging price pressures.

In that connection, the Committee believes, particularly in the light of the extraordinary expansion of this aggregate in recent years, much slower monetary growth would be appropriate in the context of signs of intensifying price pressures, relatively strong growth in the broad monetary aggregates, excessive weakness of the dollar in exchange markets, and continuing economic expansion. Conversely, continuing sizable increases in M1 could be accommodated in circumstances characterized by sluggish business activity and maintenance of progress toward underlying price stability. As this implies, the Committee in reaching operational decisions during the year, will evaluate appropriate growth in M1 from time to time in the light of circumstances then prevailing, including the rate of growth of the broader aggregates.